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Southeast Asia: Strains of the Global Recession [redacted]

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An Intelligence Assessment

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December 1982

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Southeast Asia: Strains of the Global Recession [redacted]

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An Intelligence Assessment

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This paper was prepared by [redacted] of the Office of East Asian Analysis. It was coordinated with the National Intelligence Council. Comments and queries are welcome and may be directed to the Chief, Southeast Asia Division, OEA, [redacted]

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Southeast Asia: Strains of the Global Recession

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Key Judgments

Information available as of 19 November 1982 was used in this report.

The four major commodity-dependent Southeast Asian countries—the Philippines, Thailand, Malaysia, and Indonesia—are being hit hard by the global recession. Prices for agricultural products and industrial raw materials—which account for the bulk of exports and domestic employment—have fallen, occasionally to levels not experienced since the Depression. Growth of manufactured exports, normally the most buoyant economic sector in each of these countries, has slowed or even declined. As a result, current accounts have deteriorated and domestic growth has slowed substantially.

Area governments now face dilemmas as revenue shortfalls pressure them to adjust budgets and as current account deficits increase borrowing requirements or force measures to limit imports. Malaysia has already cut back on a wide variety of programs, including defense and education; Thailand and the Philippines are also beginning to reduce domestic spending. Indonesia, squeezed by declining real oil prices and rapidly rising imports, also faces some difficult budget decisions over the next few months.

In terms of US interests, one of the most important elements of the recession is its political impact in these countries. There are signs of growing discontent:

- In Malaysia, poor economic conditions are straining latent tensions between ethnic Malays and Chinese.
- Declining wages and rising unemployment in rural areas of the Philippines are apparently aiding recruitment for the Communist insurgency.
- Unemployment, crime, and labor unrest are on the rise in areas of Indonesia.

Despite these increasing strains, none of the area governments are likely to face unmanageable social unrest over the next year. National leaders have successfully blamed problems on external sources and in some cases have implemented programs to conceal the impact of the recession. Another year or more of these economic conditions would change this sanguine assessment, however. In any case, Southeast Asian leaders, trying to deflect domestic criticism, will blame Western policies for domestic economic troubles and may turn to Washington for help—including commodity assistance and credits for internal security and defense modernization.

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EA 82-10137
December 1982

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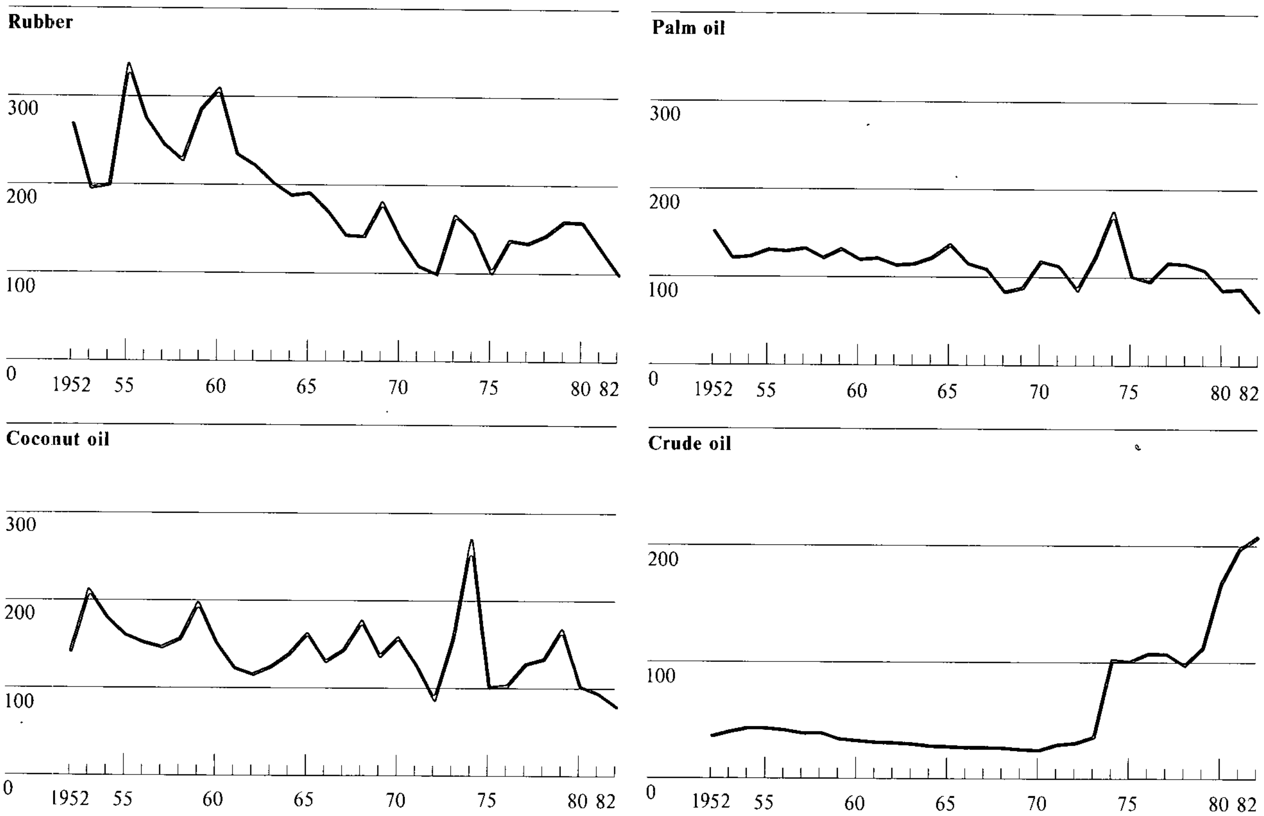
Figure 1
Southeast Asia: Purchasing Power of Selected Commodities[a]

Index: 1975=100



[a] Deflated by an export price index for industrial countries.

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Southeast Asia: Strains of the Global Recession [redacted] 25X1

Economic Problems

Compared with past performance and recent expectations, the economies of Indonesia, Malaysia, the Philippines, and Thailand—which account for nearly 60 percent of East Asia's non-Communist population—are in deep recession.[1] Prices for many agricultural goods and industrial raw materials have fallen to depressed levels (figure 1). While export prices have declined across the board, import prices have continued to rise, pushing trade accounts into the red. The aggregate export price for goods shipped from the Philippines, Thailand, and Malaysia has declined more than 10 percent over the last two years, while the cost of imports has gone up 20 percent. In fact, for Thailand and the Philippines, the ratio of export prices to import costs—the terms of trade—are at a postwar low (figure 2). [redacted]

Most of the area's basic crops have suffered price declines. The price of rice, for example, has gone down by 45 percent since mid-1981, reflecting good harvests globally last year and prospects for another good crop this year. Rice accounts for almost 20 percent of Thailand's exports. Sugar prices are also down; the London price in September was less than 6 cents per pound—11 cents below the 1981 level. In addition, palm oil prices have declined by almost 25 percent in the last five months. Palm oil is a major Malaysian export—accounting for over 10 percent of foreign earnings last year. [redacted]

Adding to the problems of declining prices, the growth in export volumes of both raw materials and manufactures has slowed or even fallen this year because of the poor economic performance of the area's main trading partners (figure 3):

- Malaysian tin, rubber, and palm oil exports have declined, as have overseas sales of Malaysian manufactured products. Among Malaysia's main exports, only oil and timber have experienced increased sales in 1982. 25X1

- Because of the OPEC quota and depressed international oil demand, Indonesia's oil exports at 300,000 barrels per day are running over 25 percent below 1981 levels. 25X1

- In the Philippines, wood, coconut, and sugar exports are down sharply. [redacted] 25X1

The dismal performance of exports is slowing economic growth in all four countries. [redacted] the weighted average growth rate among the four will fall below 4 percent in 1983—making this recession worse than the steep 1974-75 downturn. Fears about the Philippine foreign debt position, low farm incomes, and continued growth in imports have all constrained the Philippine economy, with little or no growth expected this year.[2] Austere fiscal policies coupled with low commodity prices will slow Malaysia's growth rate to less than 4 percent—nearly half the average rate over the last five years. Indonesia's economic growth should dip below 5 percent in 1982, in large measure because of the sharp decline in exports of both oil and nonoil commodities. Among the four, only Thailand will have a respectable performance by Southeast Asian standards this year, with GNP expected to grow at just under 6 percent as compared with an average of more than 7 percent over the last five years. [redacted] 25X1

[redacted]

[redacted]

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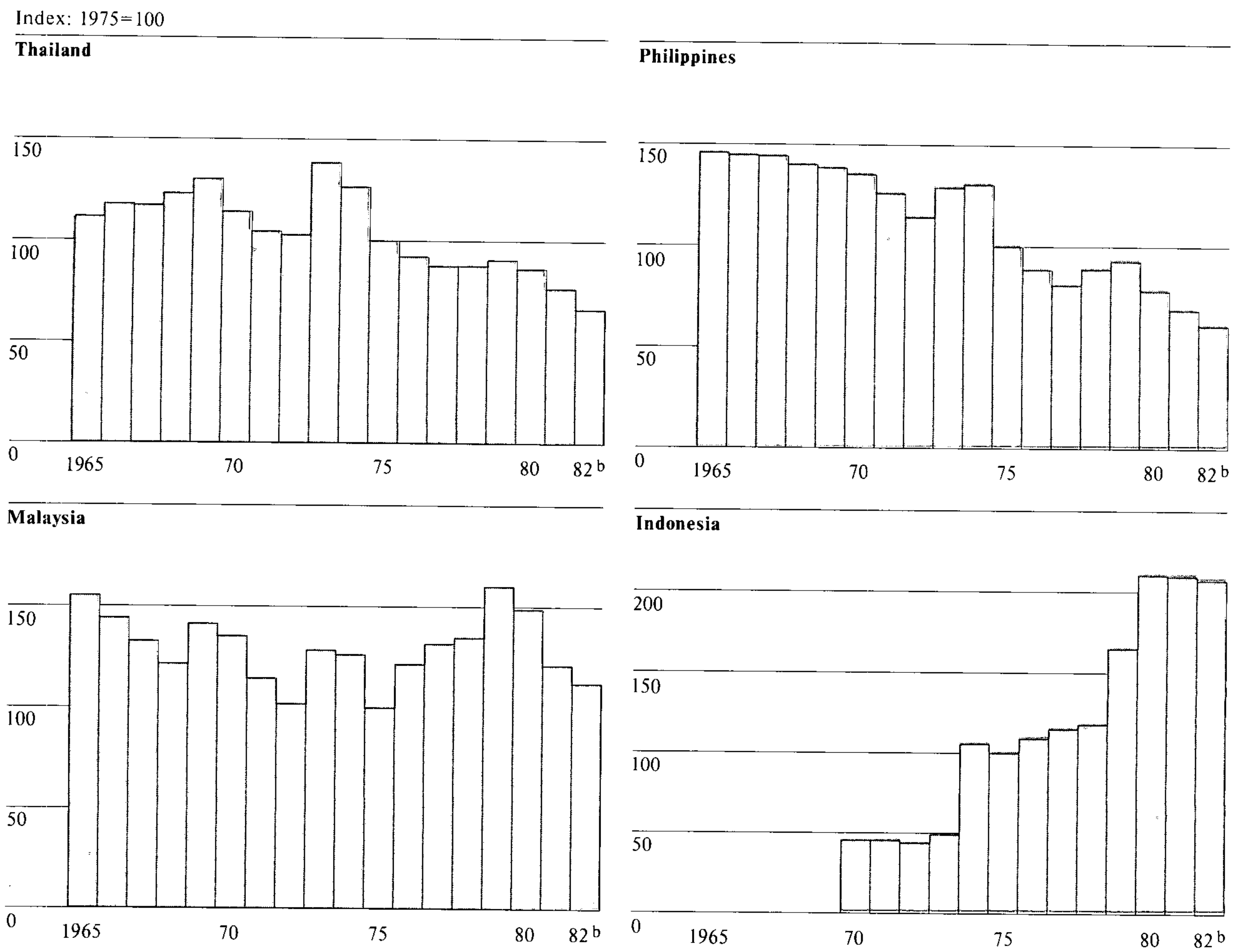
Figure 2
Southeast Asia: Terms of Trade[a]



[a] Ratio of export prices to import prices.

[b] First quarter.

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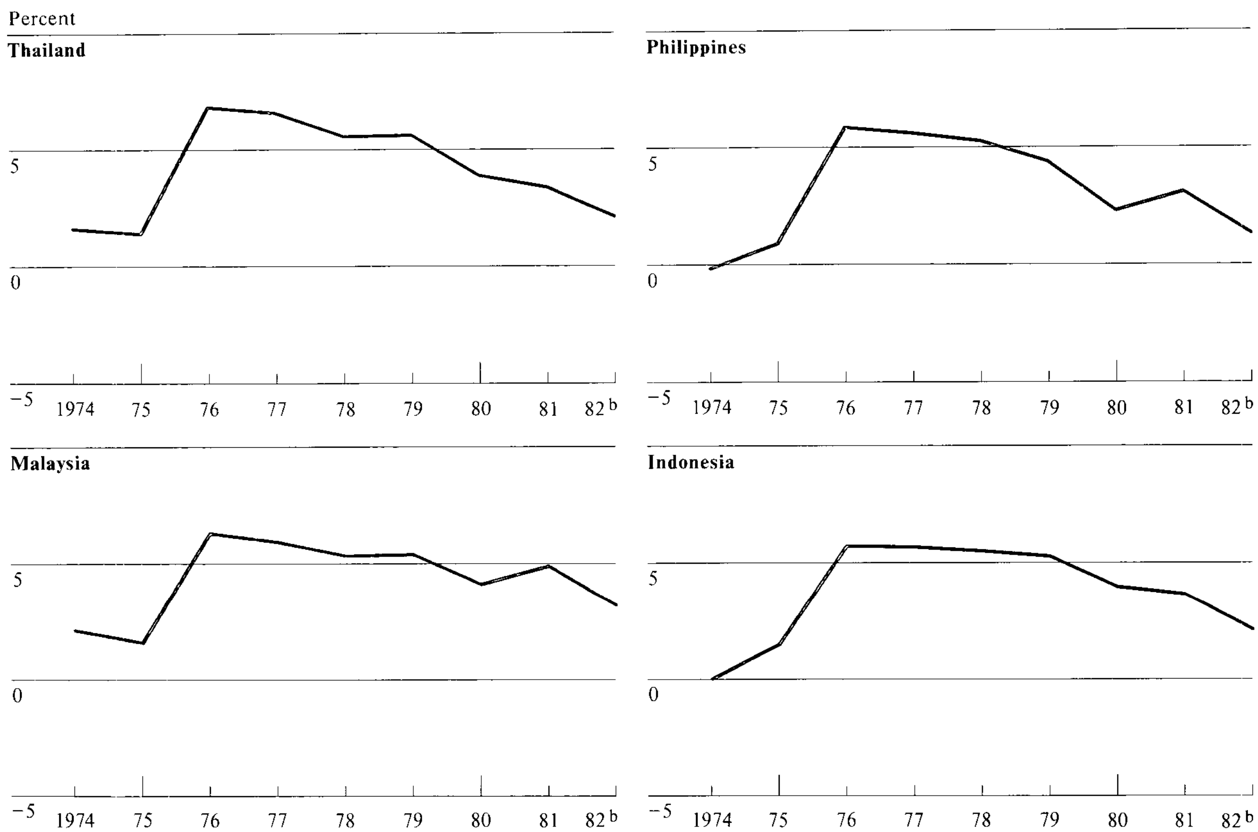
Even with slower growth, current account deficits—foreign trade in goods and services—are mushrooming in Indonesia, Malaysia, and the Philippines. The reduced volume of Indonesian oil exports, for example, costs the country $10 million per day in lost revenue and will help produce a current account deficit of $7 billion in 1982. The shortfall will increase in 1983 unless oil production is increased or strong measures are used to rein in imports. Malaysia's current account deficit could approach $4 billion this year. The red ink has forced Kuala Lumpur to become a major overseas borrower for the first time. The Philippine foreign debt is also growing rapidly; the official debt has nearly doubled since 1978. To

Figure 3
Southeast Asia: Real GDP Growth of Trading Partners[a]



[a] Weighted average.
[b] Preliminary.

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reduce capital flight, Manila has frozen applications for overseas investments by both Philippine firms and individuals. [redacted]

Growing Local Problems

In Malaysia, declining rubber prices and rising production costs are troubling both "small holders" and large plantations. The small farmers, mainly ethnic Malays, produce lower grades of rubber and bear the brunt of any decrease in demand. Some small farmers have even abandoned tapping or are replanting with oil palms. Plantations, which should be less vulnerable because most produce both rubber and palm oil, are having serious troubles, with many reporting losses in 1982. According to the US Embassy, Malaysia's private rubber producers, at the quiet request of the government, are withholding rubber from the market in an unsuccessful effort to boost prices. The producers are not getting cooperation from other countries. [redacted] 25X1

With farm incomes falling, local demand for small manufactured products and foodstuffs has slipped. Malaysian rubber workers' earnings depend to a large extent on bonuses that vary with the price of rubber.

Many laborers, in fact, are leaving the industry because of the lower wages. In the tin industry nearly 200 mines have been closed since early this year, leaving 12 percent of the country's 35,000 tin workers without jobs.

Thai farmers have been hurt by the collapse in rice prices. Prices are particularly low in the northeast—the poorest region of the country. In addition, production costs for some farmers are up substantially because of rising charges for fertilizer and fuel. A government purchase plan designed to hold up prices has not been successful because the organizations responsible for supporting prices can afford to purchase only a small portion of the harvest because of too little funding.

The budding manufacturing sectors in Malaysia and Thailand have also been affected by the recession. Production cutbacks in the Thai textile, glass, metals, and ceramics industries have contributed to rising unemployment, particularly in the Bangkok area. The Thai construction industry is in a deep slump that will be further exacerbated by the recent tax on property sales. Malaysian manufacturing output—which had been growing by nearly 10 percent a year—actually fell in the first quarter of 1982 because of a 23-percent decline in exports of manufactured goods. The recession is widespread, with the textiles, chemicals, and electronics industries hardest hit.

In the Philippines, mining companies are facing depressed conditions. Many Philippine copper mines—already burdened with heavy debt—are operating at low capacity this year and some have shut down. Manila is trying to prop up the industry by purchasing copper at above-market prices. In one case, the state-owned Development Bank of the Philippines and the Philippine National Bank are covering foreign loan obligations.

The Philippine rural economy is also being hit hard—particularly by the drop in coconut prices. Coconut farming normally provides income for at least one-third of the rural labor force. Given the squeeze between costs and receipts, many workers have been laid off. Businessmen in Mindanao report that retail sales fell 30 to 60 percent last year, reflecting the decline in rural incomes.

Even oil-rich Indonesia is facing economic problems. The lumber industry, for example, is operating at a low level because of the decline in housing construction and Jakarta's policy of restricting timber exports to promote processed wood sales. In July the government increased the funds for loans to small farmers and fishermen because of the declining incomes suffered in these occupations. Unemployment is rising—particularly among the youth in urban areas. A high-level government official recently estimated that 35 percent of the labor force between the ages of 15 and 30 is unemployed.

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Constraining Government Spending

Declining export earnings, coupled with sluggish growth, have reduced government tax revenues. Malaysian Government revenues in 1982 are running 13 percent below last year with export duties and corporate income taxes—which together account for nearly two-thirds of the government's total income—hardest hit. Indonesia's revenues are also down because taxes and royalties on the petroleum industry make up 60 percent of government income. Government receipts in Thailand and the Philippines have also slumped this year. In all four countries, debt servicing costs are growing rapidly, putting a substantial squeeze on discretionary spending.

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Malaysia trimmed its 1982 budget by over $1 billion from original plans. Education and defense expenditures were off nearly 30 percent in first quarter 1982, compared with year earlier levels, and defense expenditures this year are expected to fall some 25 percent short of the original budget.

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Expenditures for 1983 are budgeted 10 percent below the 1982 allocation, and cuts have been imposed across the board. Even the politically sensitive social services budget—which includes education, health, and housing—has been cut by a one-third. Housing expenditures—over 4 percent of the 1982 budget—have been slashed by over 50 percent. Subsidies for low-cost housing have been reduced, but food and fuel subsidies will remain at 1982 levels. Kuala Lumpur has announced it will not fill government job vacancies or create new posts. The share of debt servicing in

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the budget will nearly double to almost 14 percent in 1983. To raise revenue, the sales tax rate has been doubled, and import duties on tobacco and automobiles have been increased. This new budget reverses Kuala Lumpur's traditional policy of priming the economy during a recession. [redacted]

Revenue shortfalls have also forced Thailand to adopt an austerity budget for the next fiscal year. Expenditures are budgeted to rise less than 10 percent—only half of the average rate of increase since 1973. Nearly 40 percent of this increase will be taken up by higher debt servicing requirements. Agriculture development projects—such as improving crop yields and irrigation systems—have been hardest hit. Bangkok also has slashed subsidies for state enterprises by nearly half. The government has increased indirect taxes and slapped a 10-percent surcharge on imports to boost revenues. At the same time, personal income taxes were trimmed to relieve the burden on the poor. [redacted]

Manila's budget proposal for 1983 calls for the second reduction in real spending in as many years. While nominal spending will increase, nearly two-thirds of the rise will go to service the debt. General public services will decline in real terms. Expenditures on social services, however, are scheduled to rise—primarily because of the increased share going to education to support a projected large rise in enrollment next year and planned salary increases for teachers. [redacted]

Even Indonesia is facing tough decisions on domestic spending. The reduction in oil production is cutting into Jakarta's budget by an estimated $6 million per day. Already, Indonesia has frozen the salaries of government workers and lowered unit subsidies on food and fuel to hold down government spending. In addition, we believe some large public-sector projects may be postponed. Jakarta already is scrutinizing project proposals more closely and is requesting planners to substitute suppliers' credits for government capital where possible. Domestic taxes have been boosted, and Jakarta recently raised royalty payments on foreign corporations operating in Indonesia. [redacted]

Social Strains

There are growing signs that the recession is causing social strains in these countries. According to government officials, ethnic Malay rubber producers are blaming Chinese traders for the steep decline in 25X1 rubber prices. The government's recent decision to reduce spending on education, housing, and social services, in our opinion, will further increase Chinese-Malay tensions because poorer Muslim Malays will be hurt more than the wealthy Chinese. Scattered incidents of Malay-Chinese hostility occurred in urban areas during the 1974-75 economic downturn. [redacted] 25X1

Kuala Lumpur may be forced to cut back the popular program of acquiring Chinese- and foreign-owned 25X1 businesses for future sale to ethnic Malays. Such a bold move would be seen by Malays as catering to the Chinese. It thus could benefit the fundamentalist 25X1 Islamic political party, which—in portraying itself as the champion of Malay interests and questioning the government's commitment—made some gains in the poorest Malay areas in the national elections last April. [redacted]

In Thailand, where parliamentary elections will be held next spring, the reductions in fuel subsidies will probably cost government candidates some support. 25X1 According to US Embassy [redacted] reports, fuel price increases provoked riots, which in 1979 were at least partly responsible for the fall of the 25X1 previous government in early 1980. [redacted] 25X1

President Marcos has deftly used government subsidies to conceal problems in Philippine industries. The government, however, is still taking some heat. Part of the blame for the lower prices is being aimed at the President and his associates, who control much of the raw material processing. The US Embassy reports that an antigovernment rally held in a major sugar-producing area in late September was much larger and more antigovernment than previous demonstrations. According to Defense Department reporting,

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Communist recruitment is on the rise, particularly in the more depressed rural areas.[3]

Local politicians also have suffered as their incomes from the timber concessions granted them by the government have fallen. If, as in the past, these officials take a larger share of government development funds in graft to make up for lost timber earnings, local farmers and rural workers will be even harder hit.

In Indonesia, rising unemployment already has contributed to increased crime and violence in some areas of the country. In the plantation areas of eastern Java, for example, population pressures and unemployment have increased social tensions and are being blamed in part for the rise in murder and other serious crimes. In Surabaya, 7,000 unemployed youths rioted in late 1981, and workers at a large textile factory there attacked the owner over a wage dispute last May.

The Outlook

Improved economic conditions in Southeast Asia hinge in large part on economic recovery in the West and Japan to boost export volumes and raise prices for raw materials. Unfortunately, each revised economic forecast for the major industrial countries seems to put an upturn further off and to reduce the expected level of growth once recovery begins. Also, the link between an economic upturn and higher commodity prices is unclear. Although lower interest rates are likely to push up commodity prices as inventories are rebuilt, many analysts argue there can be a modest upturn in Western and Japanese growth without a major increase in raw materials and agricultural prices, particularly if industrial production fails to rebound significantly. Consequently, it may take more than a modest upturn in the West to boost economic fortunes in Southeast Asia.

The Philippines, Malaysia, and Indonesia are already running current account deficits that concern financial analysts. If a price recovery does not seem likely, those financial institutions that remain bullish on lending to the area could cut back credit and force drastic government policy actions. 25X1

In addition social strains undoubtedly will increase if the economic downturn continues past next year. Ethnic violence in Malaysia and Indonesia and an upsurge in the Communist insurgency in the Philippines are likely. In any case, national leaders will continue to blame the domestic economic problems on outside forces. According to US Embassy reporting, Malaysian Prime Minister Mahathir believes that the worldwide recession is largely a result of poor US economic policies—particularly the maintenance of high interest rates. Southeast Asian governments have also attributed the drop in sugar prices in part to US quotas and the EC refusal to participate in the International Sugar Agreement. 25X1 25X1

As the recession forces these countries—particularly Indonesia and Malaysia—to cut back on ambitious defense programs, the United States can expect increased requests for military credits. Should oil prices remain depressed, we believe Indonesia will look abroad for additional aid and concessionary financing of military purchases. Although the United States will remain the supplier of choice for most advanced weapon systems, the economic pressures could increase comparative shopping in Europe. 25X1 25X1

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[3] There seems to be a very strong linkage between depressed rural incomes and the NPA's recruitment success.

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